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No. A-1115
IN THE

Supreme Court of the United States

October Term, 1981

HILTON HOTELS CORPORATION, successor to FLAMINGO RESORT, INC.,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Questions Presented for Review.

1. Should this Court review the decision of the Ninth Circuit Court of Appeals, which, contrary to prior decisions of this Court and the Tax Court and the long-standing position of the Internal Revenue Service, holds that a taxpayer must accrue income and pay taxes upon mere promises to pay, even though the taxpayer does not have a legally enforceable right to collect upon such promises under any circumstances?

2. Should this Court review the decision of the Ninth Circuit Court of Appeals, which departs from the clear, certain, and administratively workable "all-events" test articulated by this Court over one-half century ago (and applied since then by this Court, the lower federal courts, and the Internal Revenue Service) to determine when income is realized by accrual basis taxpayers?

3. Should this Court review the decision of the Ninth Circuit Court of Appeals, which creates serious uncertainty for both taxpayers and the Internal Revenue Service in the timing of deductions of business expenses for accrual basis taxpayers, and which, if applied as written, may result in hundreds of millions, if not billions, of dollars in business expense deductions being accelerated to the substantial detriment of the United States Treasury?

Parties in the Court of Appeals.

Petitioner, Hilton Hotels Corporation, is the successor in interest to Flamingo Resort, Inc., the plaintiff-appellant in an action brought in the United States District Court for the District of Nevada and subsequently appealed to the United States Court of Appeals for the Ninth Circuit. The United States of America is the defendant-appellee in the District Court and in the Ninth Circuit Court of Appeals.

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ERRATA

HILTON HOTELS CORPORATION (Parent Company)

	% Hilton Ownership
Hilton Service Corporation	51
Statler Dallas Corporation	49
Main and Holcombe Corporation	40
Hilton Reservation Equipment Company	51
Beverly Hilton Joint Venture	50
Dallas Hilton Joint Venture	50
Commerce Garage Joint Venture	50
Compass Computer Services, Inc.	50
D. C. Statler Hilton Joint Venture	50
Hilton Burns Kona Partnership	50
Hilton Hawaiian Village Joint Venture	50
Los Angeles Hilton Joint Venture	50
New York Hilton Joint Venture	50
Adjacent Properties Co-Ownership	50
Rye Hilton Joint Venture	50
San Francisco Hilton Joint Venture	50
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OPINIONS BELOW.

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 664 F.2d 1387 (9th Cir. 1982), and is set out at page 1 of the Appendix (hereinafter cited as "App. ....").

The opinion of the United States District Court for the District of Nevada is reported at 485 F. Supp. 926 (D. Nev. 1980), and is set out at App. 10.

GROUNDS FOR INVOKING THIS COURT'S JURISDICTION.

The decision of the United States Court of Appeals was issued January 7, 1982. Plaintiff-appellant timely filed a Petition for Rehearing En Banc, which was denied by the United States Court of Appeals in an order entered April 2, 1982. A copy of the order is set out at App. 38. On June

23, 1982, Justice Rehnquist signed an order allowing Hilton until July 26, 1982 to file this petition.

The jurisdiction of the Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATIONS INVOLVED.

Section 446 of the Internal Revenue Code, 26 U.S.C. § 446, provides, in relevant part:

> (a) General rule. — Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) Exceptions. — If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.
>
> (c) Permissible methods. — Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting —
>
> (1) the cash receipts and disbursements method;
>
> (2) an accrual method;
>
> (3) any other method permitted by this chapter; or
>
> (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

Section 451 of the Internal Revenue Code, 26 U.S.C. § 451, provides, in relevant part:

> (a) General rule. — The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing

taxable income, such amount is to be properly accounted for as of a different period.

Treasury Regulation § 1.446-1(c)(1)(ii) provides, in relevant part:

> (ii) Accrual method. Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations.

Treasury Regulation § 1.451-1(a) provides, in relevant part:

> (a) General rule. Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

STATEMENT OF THE CASE.

The Internal Revenue Service asserted a deficiency in the income tax payments of Flamingo Resort, Inc., for the period from August 17, 1967, the date of its incorporation, to December 31, 1967. Hilton later acquired Flamingo and

succeeded to its rights and liabilities for the period in question, as well as subsequent years. On December 22, 1975, Hilton, on behalf of Flamingo, paid the asserted deficiency together with interest, which amounts to $265,034.34, and filed a claim for a refund in the same amount. Following the denial of this claim by the Internal Revenue Service, this action in the name of Flamingo was commenced in the District Court to recover the overpayment, pursuant to 28 U.S.C. § 1346(a)(1).

Flamingo was the legal, licensed owner and operator of a gaming resort in Las Vegas, Nevada, known as the Flamingo Hotel and Casino. During the time in question, Flamingo operated games of chance as a regular and substantial part of its legitimate business activity. Many patrons gambled with chips obtained in return for either cash or a "marker" in the amount of the chips transferred to the patron. A "marker" is, in form, a promise to pay. Because markers issued for gambling purposes are legally unenforceable, these instruments simply "mark" the amount of gaming credit extended to a patron.

Exchanges of cash or markers for chips occurred either in the "pit" area, where the games of chance were conducted, or at the "cage," an enclosed portion of the gaming area with cashiers' windows resembling tellers' windows in a bank. This distinction gives rise to markers being termed "pit markers" or "cage markers," depending upon where such exchanges occurred.

Markers, the consideration for which is used in gambling, as well as any instrument given in payment of a gambling debt, are and always have been absolutely void and unenforceable under Nevada law, even in the hands of a holder in due course. *Sandler v. District Court*, 96 Nev. 622, 614 P.2d 10 (1980); *Sea Air Support, Inc. v. Herrmann*, 96 Nev. 574, 613 P.2d 413 (1980); *Corbin v. O'Keefe*, 87

Nev. 189, 484 P.2d 565 (1971); *Wolpert v. Knight*, 74 Nev. 322, 330 P.2d 1023 (1958); *Weisbrod v. Fremont Hotel*, 74 Nev. 227, 326 P.2d 1104 (1958); *West Indies v. First Nat. Bank*, 67 Nev. 13, 214 P.2d 144 (1950); *Burke v. Buck*, 31 Nev. 74, 99 P. 1078 (1909); *Evans v. Cook*, 11 Nev. 69 (1876); *Scott v. Courtney*, 7 Nev. 419 (1872). Consequently, Flamingo could not enforce collection of such markers anywhere. *Intercontinental Hotels Corp. (Puerto Rico) v. Golden*, 254 N.Y.S.2d 527 (N.Y. 1964); *Dunes Hotel & Country Club of Las Vegas v. Mayo*, 354 N.Y.S.2d 62 (N.Y. City Ct. 1974); *Hamilton v. Abadjian*, 179 P.2d 804 (Cal. 1947).

Flamingo reported taxable income on the accrual method of accounting. In computing its income tax liability for 1967, Flamingo did not treat its unpaid markers as assets or revenue for tax purposes. The Internal Revenue Service did, and increased Flamingo's income for the year by including as "casino receivables" unpaid markers in the amount of $676,432 on hand on December 31, 1967, less $130,721 which was treated as an addition to Flamingo's reserve for bad debts. Flamingo instituted the District Court action to recover the additional tax it was compelled to pay for the tax period in question as a result of this assessment.

During the District Court proceedings, Flamingo moved for partial summary judgment with respect to its liability for taxes on "pit markers."[1] The Government responded

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[1]The Nevada Supreme Court has developed certain presumptions with respect to instruments regular in form but asserted to have been executed in furtherance of a gambling transaction. *See Craig v. Harrah*, 66 Nev. 1, 6, 201 P.2d 1081, 1084 (1949). Consequently, an instrument cashed at a casino cage may be enforceable, if its maker fails to establish that the proceeds therefrom were used for gambling. On the other hand, if an instrument is exchanged for chips at or near a game of chance, during the progress of play, by one engaged in gambling, a gambling purpose is imputed, and the instrument is unenforceable. *Wolpert v. Knight, supra; Craig v. Harrah, supra; Burke v. Buck, supra.*

by moving for summary judgment on all markers, contending that legal enforceability was irrelevant because the exchange of a marker for chips was, in essence, a loan from Flamingo to its patron; that this "loan" and its subsequent collection, if collection occurred, were non-taxable events; that when Flamingo won back chips (which the patron had "borrowed") income was realized; and that the amount of such "income" was measured by the amount of the marker.[2]

While these motions were under submission in the District Court, the Government and an unrelated taxpayer were litigating the *identical* legal issue on substantially identical operative facts in the United States Tax Court. *Desert Palace, Inc. v. Commissioner*, 72 T.C. 1033 (1979). In *Desert Palace*, in which the Tax Court held for the taxpayer, the Government unequivocally acknowledged that Flamingo was correct in asserting that legal enforceability of a promise to pay was essential to accrual of the promise as income. In written response to questions posed by the Tax Court, the Government stated:

> Legal enforceability of casino receivables is a necessary ingredient in determining when the petitioner's right to receive gambling income is fixed within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii). Under an accrual method of accounting, income accrues only when all the events have occurred which fix the taxpayer's right to receive such income. *United States v. Anderson*, 269 U.S. 422 (1926); *Spring City Co. v. Commissioner*, 292 U.S. 182 (1934). *The unenforceability of the gambling debts receivables affects the accrual of income in that it presents a contingency which precludes accrual of income under the all events*

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[2]The District Court eventually rejected this argument of the Government. *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926, 937 (D. Nev. 1980).

> *test of Treas. Reg. § 1.446-1(c)(1)(ii).* [Emphasis added.]

Tax Court's Order, dated December 8, 1978, and Supplemental Brief for Respondent (the Government) in the *Desert Palace* case, set out in full in the Appendix to this petition, beginning at page 39 and page 40, respectively.

Thereafter, in this action in the District Court, the Government reiterated this interpretation of the Treasury Regulations involved:

> The *Desert Palace* case deals with issues identical to those in the instant case. It is true that the Government there argued that, due to the legal unenforceability of pit markers, the taxpayer casino need not accrue income upon the *receipt* of such markers. It is likewise true that the Government there stipulated that outstanding chips do not represent *legal* obligations of the casino. The latter point is a matter of Nevada law, and we do not deviate in the slightest from those positions in this case.

Reply Memorandum of Points and Authorities in Support of the Government's Cross-Motion for Summary Judgment, set out in full in the Appendix beginning at page 43, at page 47 (emphasis by the Government).

Notwithstanding this construction of its own Treasury Regulation by the Government in two independent cases, the District Court held that "the income represented by casino receivables is accruable under the 'all events' test" because "legal enforceability is not a necessary element of a fixed right to receive income." *Flamingo Resort, Inc. v. United States*, 485 F. Supp. 926, 939 (D. Nev. 1980). On this basis the District Court granted summary judgment to the Government.

Flamingo appealed. The Ninth Circuit Court of Appeals affirmed, agreeing with the District Court that because

Flamingo had a "reasonable expectancy of collection" of many of its markers, "accrual was proper despite the absence of legal enforceability." *Flamingo Resort, Inc. v. United States*, 664 F.2d 1387, 1388, 1390 (9th Cir. 1982).

Hilton Hotels Corporation, as successor in interest to Flamingo, now petitions this Court to review this conclusion by a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

REASONS FOR ALLOWANCE OF THE WRIT.

I.

THE NINTH CIRCUIT HAS ABANDONED LEGAL ENFORCEABILITY AS AN ESSENTIAL ELEMENT FOR THE ACCRUAL OF INCOME, THEREBY CREATING A CONFLICT WITH PRIOR DECISIONS OF THIS COURT, OTHER COURTS OF APPEAL, THE TAX COURT, AND WITH THE LONG-STANDING POSITION OF THE INTERNAL REVENUE SERVICE ON THE MEANING AND APPLICATION OF THE ALL-EVENTS TEST.

The conflict just described is real, as demonstrated in the following paragraphs.

A. Decisions of This Court.

More than fifty years ago, this Court enunciated the test which governs accrual accounting for income tax purposes to this day. In *United States v. Anderson*, 269 U.S. 422, 46 S.Ct. 131, 70 L.Ed. 347 (1926), the question presented was the deductibility of a tax, which had not been assessed, and thus was not yet due and payable. Holding that a deduction was nevertheless proper, this Court observed that

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all of the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.

269 U.S. at 441.

Four years later the Court applied this "all-events" test to the corresponding question of the accrual of income for income tax purposes. In *Lucas v. North Texas Lumber Co.*, 281 U.S. 11, 50 S.Ct. 184, 74 L.Ed. 668 (1930), an executory contract for the sale and purchase of certain real property was entered into prior to the end of the tax year. Closing of the transaction, including payment of the pur-

chase price, was contingent only on the exchange of the necessary papers, but this did not occur until the next year. As a result, this Court refused to permit the taxpayer (the vendor) to accrue the income represented by the purchase price of the property because "The title and right of possession remained in [the vendor] until the transaction was closed. Consequently, unconditional liability of vendee for the purchase price was not created in that year." 281 U.S. at 13.

At all times since these two decisions, unconditional liability of the debtor has been an unwavering requirement for the accrual of income and deductions for tax purposes. Thus in *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197 (1932), this Court rejected the Government's contention that income should be accrued prior to the entry of a court decree vacating a receivership. In the Court's view, the decree would be necessary to establish the "*right* in the [taxpayer] company to demand" payment of profits paid to the receiver (the income in dispute). 286 U.S. at 423 (emphasis added).

Two years later, in *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 54 S.Ct. 644, 78 L.Ed. 1200 (1934), this Court required the accrual of an account receivable in full, even though a petition in bankruptcy had been filed against the account debtor, saying: "Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues." 292 U.S. at 184-185 (emphasis in original).

Consistent with *Spring City Foundry* this Court in *United States v. Safety Car Heating & Lighting Co.*, 297 U.S. 88, 56 S.Ct. 353, 80 L.Ed. 500 (1936), precluded an accrual

basis taxpayer from including income received as a result of patent infringement litigation as taxable income for the year in which its claim arose, reasoning that "the existence of any liability was contested and uncertain" until the infringement issue was decided and "[t]he amount remained contested and uncertain" until several years later, "when there was a settlement of the liability. . . . Then for the first time the profits flowing from the infringement became taxable as income." 297 U.S. at 93-94

And in the same vein in *Estate of Putnam v. Commissioner*, 324 U.S. 393, 65 S.Ct. 811, 89 L.Ed. 1023 (1945), this Court refused to require accrual (to a deceased taxpayer) of a corporate dividend on the date of its declaration because the dividend was payable and paid to stockholders of record on a later date. Noting that the identity of the recipient was thus not determined as of the date of declaration, this Court observed: "Such uncertainty destroys any conception of accrual as involving a *right* to receive or an obligation to pay, elements which we think are essential for accruals under our decisions." 324 U.S. at 400 (emphasis added).

That the Court's repeated reference to "right to receive" in accrual cases means "legally enforceable right" is unequivocally established by this Court's recent decision in *United States v. Byrum*, 408 U.S. 125, 92 S.Ct. 2382, 33 L.Ed.2d 238 (1972). In *Byrum* this Court considered the meaning of "right . . . to designate" in Section 2036 of the Internal Revenue Code, 26 U.S.C. § 2036(a), and concluded:

> The term 'right,' certainly when used in a tax statute, must be given its normal and customary meaning. It connotes an ascertainable and *legally enforceable power*. . . . Here, the right ascribed to Byrum was the power to use his majority position and influence over the corporate directors to 'regulate the flow of divi-

> dends' to the trust. *That 'right' was neither ascertainable nor legally enforceable and hence was not a right in any normal sense of that term.*

408 U.S. at 136-137 (emphasis added).

In short, the Ninth Circuit's decision here is in conflict with prior decisions of this Court regarding a core concept of the income tax laws.

B. Long-standing Interpretation by the IRS.

The principles set out in this Court's opinions, which are summarized above, are embodied in Treasury Regulation § 1.446-1(c)(1)(ii), which states, in pertinent part:

> *Accrual method.* Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy.

In the District Court in *this* case the Government reaffirmed without qualification the interpretation of Treasury Regulation § 1.446-1(c)(1)(ii), which it formally articulated in writing in the *Desert Palace* case.

> Legal enforceability of casino receivables is a necessary ingredient in determining when the petitioner's right to receive gambling income is fixed within the meaning of Treas. Reg. § 1.446-1(c)(1)(ii). Under an accrual method of accounting, income accrues only when all the events have occurred which fix the taxpayer's right to receive such income. *United States v. Anderson*, 269 U.S. 422 (1926); *Spring City Co. v. Commissioner*, 292 U.S. 182 (1934). The unenforce-

> ability of the gambling debts receivables affects the accrual of income in that it presents a contingency which precludes accrual of income under the all events test of Treas. Reg. § 1.446-1(c)(1)(ii).

Supplemental Brief for Respondent in the *Desert Palace* case, App. 41-42; *see* the Reply Memorandum of Points and Authorities in Support of the Government's Cross-Motion for Summary Judgment, in the District Court, App. 47.

The Government's position in the District Court in this action and in the Tax Court in *Desert Palace* is a continuation of and completely consistent with the position of the Internal Revenue Service for the last sixty years. In 1921 the Bureau of Internal Revenue issued a public pronouncement that a taxpayer who made usurious loans could not report the interest income from the loan prior to the year in which it was actually received because "the unpaid notes held by him are not legal obligations of the makers and are not collectible under due process of law." Office Decision 1139, 5 C.B. 84 (July-December 1921). This Office Decision has *never* been said to be incorrect; it was not declared obsolete until December 1974 (see Rev. Rul. 74-621, 1974-2 C.B. 405, first published in 1974-52 I.R.B. 14), despite the *directly* contrary decisions, on identical facts, in *Barker v. Magruder*, 95 F.2d 122 (D.C. Cir. 1938) and *Barker v. United States*, 26 F. Supp. 1004 (Ct. Cl. 1939), relied upon by the Ninth Circuit and the District Court in this case.[3]

Nor had the Service's position changed by 1974, which was seven years *after* the tax period involved here. In 1965

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[3]The fact the Office Decision was declared obsolete is not, however, an indication that the Commissioner believed it was incorrect. In accordance with Rev. Proc. 67-6, 1967-1 C.B. 576, a large number of older rulings were declared obsolete between 1967 and 1974, because, among other things, issues are now covered by regulations and statutes or regulations have changed, or the ruling has no precedential value because the fact situation no longer exists.

the Commissioner acquiesced in the key portion of the Tax Court's decision in *The Marquardt Corporation v. Commissioner*, 39 T.C. 443 (1962), *acq.* 1965-2 C.B. 6, *non-acq. as to another issue*, 1965-2 C.B. 7. In *Marquardt Corporation* the Tax Court refused to require a taxpayer customarily reimbursed by Boeing Aircraft Company for cost overruns to accrue the reimbursements when the overruns occurred because Boeing was not legally obligated to make such reimbursements under its contract with the taxpayer. The Tax Court declared:

> Under the accrual method of accounting, an item of income accrues when the taxpayer has a fixed unconditional right to receive it. It is the right to receive and not the actual receipt of an amount which determines its accruability. *Spring City Co. v. Commissioner*, 292 U.S. 182 (1934); *Estate of Putnam v. Commissioner*, 324 U.S. 393 (1945). Until the right to an amount becomes accruable through the fixing of the right to receive, the taxpayer is under no obligation to return it as income.
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> We are concerned with the facts as they existed on December 31, 1953. [Citation omitted.] As of that date, petitioner had no fixed or unconditional right to receive any sum in excess of that authorized by Boeing. . . . There is little doubt that petitioner hoped and desired that it would get paid. However, this is not the test of accruability. The question is whether petitioner had a fixed or unconditional right. *Spring City Co. v. Commissioner, supra.*
>
> Respondent next contends that petitioner customarily overexpended and Boeing customarily overpaid the authorized amounts. Respondent contends that there was no substantial contingency barring petitioner's right to receive and Boeing's obligation to pay the amount in dispute.

> The facts do not support this contention. Even if petitioner had customarily overexpended, this unilateral action would not fix Boeing's obligation to pay, the thing necessary to require accrual. . . . Furthermore, respondent's argument overlooks the fact that the discretion to pay or not was in *Boeing*, not petitioner.

39 T.C. at 451-452 (emphasis in original).

In view of the Commissioner's acquiescence in this portion of *Marquardt Corporation*, the Government's interpretation of Treasury Regulation § 1.446-1(c)(1)(ii) presented in this case to the District Court, and to the Tax Court in *Desert Palace*, represents a position the Commissioner has maintained for over 60 years, since first asserting it in O.D. 1139, 5 C.B. 84 (July-December 1921), five years prior to this Court's decision in *United States v. Anderson, supra*. The Ninth Circuit's opinion is in irreconcilable conflict with this long-standing administrative interpretation and appears to ignore this Court's recent declaration on the weight to be accorded the Commissioner's interpretation of his own regulation.

In *Jewett v. Commissioner*, ... U.S. ..., 102 S.Ct. 1082, 1090 (1982), this Court reviewed in depth the history of Treasury Regulation § 25.2511-1(c), promulgated in 1958, and adopted the Commissioner's position saying:

> The Commissioner's interpretation of the regulation has been consistent over the years and is entitled to respect. This canon of construction, which generally applies to the Commissioner's interpretation of the Internal Revenue Code, *see* Commissioner v. Portland Cement Co. of Utah, 450 U.S. 156, 169, 67 L.Ed.2d 140, 101 S.Ct. 1037, is even more forceful when ap-

plied to the Commissioner's interpretation of his own regulation.

See also United States v. Leslie Salt Co., 350 U.S. 383, 396-397, 76 S.Ct. 416, 100 L.Ed. 441 (1956).

II.

THE NINTH CIRCUIT'S DECISION REQUIRES AN AD HOC, UNCERTAIN, AND ADMINISTRATIVELY UNWORKABLE APPROACH TO A CORE ISSUE OF THE INCOME TAX LAWS, WHICH IS SIGNIFICANT TO MILLIONS OF TAXPAYERS AND TO THE UNITED STATES TREASURY.

The Tax Court decisions in *Desert Palace* and *Marquardt Corporation*, discussed above, put that court in square conflict with the Ninth Circuit's decision in this case. Although the Ninth Circuit opinion arises out of an industry operating in only two states and on its face does not address the accrual of deductions from income, it would be a grave mistake to deem the opinion as being of little national significance, or as having minimal impact on private compliance with, and public administration of, the income tax laws. To the contrary, this is a case of profound significance in tax law and to the Government and all accrual basis taxpayers. Four real reasons support this conclusion.

First, it is common knowledge that a great number of taxpayers, including many of the Nation's major businesses, report income and expenses on the accrual basis. As a matter of fact, *every* business which maintains an inventory for sale *must* use the accrual method. Treasury Regulation § 1.446-1(c)(2)(i).

Second, legal enforceability as a prerequisite to the accrual of income is an issue of general concern. The issue is not limited to casino gaming or to the banking industry and its skirmishes with state usury laws. As demonstrated by the *Marquardt Corporation* case (manufacturing), the

issue may arise in any industry. The common, recurring fact pattern is simply this: Payor, in its discretion, regularly makes payments (without the legal obligation to do so) to an accrual basis taxpayer.

The ubiquity of this fact pattern leads to the third reason this case is of great national significance: The long-established approach to accrual of income — the approach mandated by this Court's opinions and the long-standing interpretation of the Internal Revenue Service — is founded on "legal enforceability." That term has meaning, shape, and substance to taxpayers in complying with the federal tax laws and to the Internal Revenue Service in administering them. Until the Ninth Circuit's opinion, both taxpayers and the Service had in the easily understood and applied standard of "legal enforceability" a tool that cut relatively cleanly between accrual and non-accrual and which made for fairness and certainty, primary goals of the tax laws. As pointed out in *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 285-286, 64 S.Ct. 596, 88 L.Ed. 725 (1944), the tax law must be neutral; exceptions should not be made "for the benefit of the Government or the taxpayer . . . because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer."

In stark contrast, the Ninth Circuit's approach is *ad hoc*, uncertain, and administratively unworkable. Under the Ninth Circuit's newly-fashioned approach, an expectation of payment can operate to elevate a taxpayer's legally unenforceable expectation to a "fixed right to receive": Flamingo collected up to 96 percent of its markers; hence it must accrue *all* markers. But what of 95 percent or 89 percent or 73 percent? How consistent must the payment history be? No more than 5 percent deviation from the mean? 10 percent? 50 percent? And how long a payment history?

Six months, twelve months, five years? These questions must be answered on a case-by-case basis under the Ninth Circuit's approach.[4]

The fourth reason for the belief that this case is significant offers, in our opinion, the strongest justification for this Court to review the Ninth Circuit's decision: The decision destroys the Government's ability to control and limit the timing and character of *deductions* from income for business expenses by accrual basis taxpayers. This could have a devastating effect on the Treasury. The reason for this result is simple and irrefutable: Accrual of income and accrual of deductions are simply two sides of the *same* coin; the same principles which govern the accrual of income also govern the accrual of expenses. Indeed, the venerable "all-events" test and the notion that legal liability is a central requirement for accrual accounting were first enunciated by this Court in the context of the deductibility of expenses. *United States v. Anderson, supra; see also, United States v. Consolidated Edison Co.*, 366 U.S. 380, 81 S.Ct. 1326, 6 L.Ed.2d 356 (1961); *Security Flour Mills Co. v. Commissioner*, 321 U.S. 281, 64 S.Ct. 596, 88 L.Ed. 725 (1944); *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516, 64 S.Ct. 364, 88 L.Ed. 270 (1944). In sum, if mere expectations without legal enforceability require accrual of income (as the Ninth Circuit held), they will also permit accrual of deductions.[5]

That result of the Ninth Circuit's opinion reveals two glaring, significant flaws in the opinion. First, the decision

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[4]We are not creating a parade of horribles here; nor is this mere rhetoric. This is the reality of the Ninth Circuit's decision.

[5]This will be the conclusion of not only creative and imaginative tax analysts, advisers, and planners but of the most conservative and literal of that group. This effect of the Ninth Circuit's opinion cannot be ignored.

is flatly contrary to prior decisions of this Court and the long-standing public interpretation of them by the Internal Revenue Service, which permit deduction of only those expenses which meet the all-events test, and which reject the Ninth Circuit's "mere expectations" concept. In *Brown v. Helvering*, 291 U.S. 193, 54 S.Ct. 356, 78 L.Ed. 725 (1934), this Court rejected the deductibility of reserves for anticipated refunds of insurance premiums due to policy cancellations, saying that:

> The liability . . . arising from expected future cancellations was not deductible from gross income because it was not fixed and absolute. In respect to no particular policy written within the year could it be known that it would be cancelled in a future year. Nor could it be known that a definite percentage of all the policies will be cancelled in the future years. *Experience taught that there is a strong probability that many of the policies written during the taxable year will be so cancelled. But experience taught also that we are not dealing here with certainties.*

291 U.S. at 201 (emphasis added). The Internal Revenue Service has consistently adhered to this same standard in determining the accrual of deductible expenses. *See, e.g.*, Rev. Rul. 72-34, 1972-1 C.B. 132-33.[6]

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[6]The Treasury Regulations with respect to bad debt deductions also illustrate this position. Treasury Regulation § 1.166-1(c), which permits a bad debt deduction only if there is a bona fide debt, also states: "A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid *and enforceable* obligation to pay a fixed or determinable sum of money." (Emphasis added.)

It would be anomalous, if not unconstitutional, to apply the Ninth Circuit's opinion to require Flamingo to *pay* taxes on unenforceable promises to pay but *deny* it a bad debt deduction for uncollectible ones. Yet they may well be a result of the Ninth Circuit's holding, which, according to that Court, leaves Nevada law intact and markers unenforceable at the same time this Treasury Regulation denies a deduction for bad debts on the same ground. *See Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 189 (1934).

In effect, the Ninth Circuit's opinion in this case, if allowed to stand, may overrule *Brown v. Helvering* and herald the end of years of consistent application of the all-events test, which is both fair and easily understood by taxpayers and the Government. For the first time millions — if not billions — of dollars of reserves for future expenses will be deductible. Examples of such reserves for statistically determinable expenses which would be deductible for the first time, and the cases or Internal Revenue Service rulings which heretofore have held such are not, include: reserve for future warranty service [*Bell Electric Co.*, 45 T.C. 158 (1965)]; reserve for self-insurers for future workmen's compensation claims [*Thriftimart, Inc.*, 59 T.C. 598 (1973); Revenue Ruling 70-262, 1970-1 C.B. 122]; reserve for liability for accidents [*Richmond Light & Railroad Co.*, 4 B.T.A. 91 (1926)]; reserve for future required maintenance expense [*World Airways, Inc.*, 62 T.C. 786 (1974), *aff'd* 564 F.2d 886 (9th Cir. 1977)]; reserve by cargo carriers for cargo loss and damage claims [*Gateway Transportation Co., Inc. v. United States*, 77-1 U.S.T.C. ¶9131 (W.D. Wis. 1976) (not officially reported)]; reserve by publishers for returns of unsold books [*J. J. Little & Ives & Co.*, T.C. Memo 1966-1968]; reserve for returns of unsold magazines from distributors [*Readers' Pub. Corp. v. United States*, 40 F.2d 145 (Ct. Cl. 1930)]; reserve for anticipated teaching expenses under contracts for dance instruction [*Villafranca v. Commissioner*, 359 F.2d 849 (6th Cir. 1966)]; reserve for sales commission due when payment received from customers [*Reuben H. Donnelley Corp.*, 22 B.T.A. 175

(1931)]; reserve for return of returnable bags [*LaSalle Portland Cement Co.*, 4 B.T.A. 438 (1926)].[7]

In sum, the Ninth Circuit's approach is in direct conflict with the fundamental principles underlying both this Court's decision in *Brown v. Helvering, supra*, and the publicly announced position of the Internal Revenue Service through rulings, bulletins, and Treasury Regulations.

Because the Ninth Circuit's opinion replaces "legal enforceability" with "mere expectation" as the definitive test for the accrual of income *and* deductions, taxpayers will now have a powerful device for manipulating the *timing* of their deduction of business expenses and for manipulating the *amount* of taxes paid by them. We believe this unhappy prospect was a major factor in causing the Internal Revenue Service to adhere to "legal enforceability" for 60 years of consistent administrative interpretation and in this very case. The Ninth Circuit simply "missed" this point and the profound impact of its decision on the Federal fisc.

CONCLUSION.

For taxpayers in the Ninth Circuit, there no longer need be a liability that is fixed, absolute, and certain for accrual of income and the deduction of expenses. A strong prob-

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[7] In Rev. Rul. 74-69, 1974-1 C.B. 113, the Internal Revenue Service acknowledged that prospective expenses incurred by a gambling machine operator could not be accrued as current expenses because payment of them could not be legally enforced. The Service ruled that a gambling machine operator who gave winning customers coupons redeemable in merchandise from cooperating merchants, whom the operator then paid for the merchandise could *not* deduct the value of the coupons when issued. The operator could deduct the value of the coupons only "when the taxpayer becomes liable to pay the participating merchant for the merchandise used to redeem the coupons." That occurred on redemption.

Inasmuch as Rev. Rul. 74-69 was issued in the same year that Office Decision 1139 was declared obsolete, see page 11, *supra*, for discussion, it is clear that the Commissioner did not change his insistence on legal enforceability as a prerequisite to accrual.

ability, a mere "expectation," may now require accrual, depending on a factfinder's conclusion on the presence or absence, according to the Ninth Circuit, of "unique facts and practical considerations." 664 F.2d at 1389. This is not the way in which the tax laws can be meaningfully acted on by taxpayers or applied by the Internal Revenue Service, nor should it be.

This Court should grant a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit to review its decision in this case.

Respectfully submitted,
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